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July 3, 1995

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
Mail Stop 1170
1919 M Street, N.W., Room 222
Washington, DC 20554

DOCKET FILE COPY ORIGINAL

Dear Mr. Caton:

Re: CC Docket No. 87-313, Policy and Rules Concerning Rates for Dominant Carriers

CC Docket No. 93-197, Revisions to Price Cap Rules for AT&T

On behalf of Pacific Bell and Nevada Bell, please find enclosed an original and six copies of their "Comments of Pacific Bell and Nevada Bell" in the above referenced proceeding.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions or require additional information concerning this matter.

Sincerely,

Jay Bennett

Enclosure

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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Policy and Rules Concerning Rates for Dominant Carriers	))	CC Docket No. 87-313
	)	CC Docket No. 93-197
Revisions to Price Cap Rules for AT&T	))	

COMMENTS OF PACIFIC BELL AND NEVADA BELL

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Date: July 3, 1995

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SUMMARY

The Commission proposes changes in AT&T's price cap rules that would enhance AT&T's ability to offset discounts to high-volume customers with price increases to the majority of AT&T's customers who pay standard MTS rates. As the Commission itself acknowledges, prices for standard MTS already have risen substantially. There is little if any competition in the standard MTS market. AT&T, Sprint and MCI, with a combined long distance market share of about 90%, raise standard MTS prices in lockstep, in the knowledge that customers have, as a practical matter, nowhere else to go.

It would be contrary to its statutory obligations and price cap goals for the Commission to encourage even greater subsidies from standard MTS customers to AT&T's other ventures. The Commission has never examined or explained why standard MTS rates have risen while costs are falling. The Commission suggests that AT&T fails to recover its marginal costs of serving "low-volume" standard MTS customers. Yet no evidence supports this claim; it is unrelated to the Commission's much broader proposal to allow price increases to all basic MTS customers; and it is irrelevant to the "like services" test.

We commend the Commission for recognizing that by using projected demand for promotions and discounts when it calculates its APIs, AT&T may have overstated its "headroom". But that is not the only way AT&T has creatively interpreted the price cap rules in a way that undermines price cap goals. AT&T apparently includes "wraparound" intrastate discounts in its interstate APIs. By this means, the revenues that AT&T forgoes competing in the intraLATA toll market may be recovered from interstate standard MTS customers. That is

not competition. It is a shell game in which revenue recovery is shifted to the less competitive jurisdiction, but consumers as a whole do not enjoy lower prices. This unreasoned subsidy and its anticompetitive effects can only increase as intraLATA toll competition intensifies throughout the nation. We request the Commission examine this practice and explain how such revenue shifting advances price cap and universal service goals. Already, the Commission's own data show a decline in telephone penetration, which studies suggest is sensitive to high MTS rates.

If the Commission adopts its proposals, we would support the replacement of the residential index, which has not been effective at protecting basic MTS customers from price increases because it includes discount plans, with a basic rate index. However, there should be no upward flexibility in the basic rate index. The basic rate index should be imposed only after AT&T's headroom has been reformed by the removal of overstated demand for promotions, discounts on intrastate calls, and accounting costs such as SFAS 106 and SFAS 112 that are not allowed in the LECs' PCIs.

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Policy and Rules Concerning Rates for Dominant Carriers	)	CC Docket No. 87-313
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COMMENTS OF PACIFIC BELL AND NEVADA BELL

In accordance with the Commission's Further Notice of Proposed Rulemaking ("FNPRM"),[1] Pacific Bell and Nevada Bell ("the Pacific Companies") hereby respectfully comment on the regulation of services provided by AT&T Corporation ("AT&T") subject to price cap treatment.

I. Introduction

We have frequently voiced support for streamlined regulation of competitive markets.[2] However, we respectfully oppose changes to AT&T's price cap rules that would allow further increases in standard (that is, undiscounted) MTS rates.

The standard MTS market, which includes most of America's telephone users, has behaved in a way that competitive markets rarely, if ever, do: it has seen steady price increases during a time of rapidly falling costs. The Commission guesses that price increases might be

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[1] *Policy and Rules Concerning Rates for Dominant Carriers, Revisions to Price Cap Rules for AT&T,* CC Docket No. 87-313, 93-197, Further Notice of Proposed Rulemaking, FCC 95-198 (released May 18, 1995).

[2] See for example Comments of Pacific Bell and Nevada Bell, CC Docket No. 94-1, filed May 9, 1994.

necessary for AT&T to recover its marginal costs of serving "low volume" customers. But that is mere speculation. All that is known for certain is that prices went up, and AT&T's costs went down. That is strong evidence that the market is not competitive at all.

The Commission proposes new rules that would make it easier for AT&T to raise standard MTS rates. Yet it seems to have no firm idea of why they increased in the past. We believe the proposed new rules cannot be supported by substantial evidence. We also believe they would be contrary to the Commission's statutory duties to promote universal service and reasonable, nondiscriminatory rates.[3]

The Commission speaks of fostering greater competitiveness in the long distance market, of providing AT&T with "greater flexibility to respond promptly to developments in the interstate interexchange marketplace," of simplifying price cap procedures and reducing periods of delay caused by the tariff review process, and of treating like services "in a sensible, consistent manner." (FNPRM, para. 34.) We oppose none of these goals. However, the Commission's tentative decision to *include* promotions and OCPs in price caps in a single band with MTS services is obviously inconsistent with them all. Excluding promotions and OCPs from price caps would reduce regulatory burdens on AT&T, would increase its competitive response times, and would reduce the incentive for AT&T to charge unlike prices for like services.

The Commission's proposals are also inconsistent with the goals of price cap regulation. These include encouraging efficiency and innovation; decreasing the incentive for AT&T to shift costs from more competitive to less competitive service offerings; ensuring just

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[3] See 47 U.S.C. Sections 151, 201, 202.

and reasonable long distance rates for ratepayers, without unreasonable discrimination; promoting the universal availability of such reasonably priced service; and encouraging prices to approximate more closely marginal costs. (FNPRM, paras. 4, 33 (citations omitted).)

The proposed rules disserve these goals as well. Including OCPs and promotions in price caps enables AT&T to shift revenue recovery from more competitive to less competitive service offerings. There is no evidence that AT&T needs to raise rates for *any* undiscounted MTS users "to approximate more closely marginal costs" -- the only evidence that might explain price increases in the MTS market or justify price discrimination. But even if cost recovery from "low volume" MTS users is a problem, as AT&T says, the proposed rules, which would allow further annual increases of up to 5% to *all* standard MTS users, go far beyond what may be necessary to solve it. If it is not recovering its costs, AT&T has the option under its price cap rules of filing above-cap MTS rates supported by an average variable cost (AVC) showing. To our knowledge AT&T has never done so. Sometimes, silence is worth a thousand words.

II. The Proposal

The combined effect of the rule changes proposed in the FNPRM would be to allow further increases in standard MTS rates, almost assuring that most long distance customers never benefit from access charge reductions. The Commission suggests:

- AT&T's Basket 1 promotions and Optional Calling Plans (OCPs) should be included in price caps. (FNPRM, para. 35.) Their effect on APIs and SBIs would be calculated using actual demand from a shortened base period. (FNPRM, paras. 55, 56.)
- The four MTS service categories in Basket 1 (domestic day MTS; domestic evening MTS; domestic night/weekend MTS; and ReachOut America) should be combined in a single service category. (FNPRM, para. 41.)

- The residential index in Basket 1 should be replaced with a basic rate index, which would prevent AT&T from raising basic rates by more than 5 percent per year compared with the Basket 1 PCI. (FNPRM, para. 65.)

The Commission seeks comment on whether increases in basic schedule rates for domestic MTS -- the presumed effect of the rule changes -- would "implicate [its] statutory and policy goals, pursued through price cap regulation, of just and reasonable rates, without unreasonable discrimination, and universal availability of such reasonably priced service"; the relationship of AT&T's basic rate to the basic rates of its competitors; "the relationship, if any, of increased basic schedule service rates for domestic MTS with the disconnection of local telephone subscribers due to nonpayment of toll charges"; and whether "the Communications Act's protections against unreasonable discrimination are implicated ... if rate differences between AT&T's basic schedule services and its discounted offerings reflect a wider variation than corresponding cost differences." (FNPRM, paras. 58, 59, 61, 62.)

We respond to these questions below, after briefly reciting the facts we believe should guide the Commission in its decision.

III. The Facts

Critical to understanding AT&T's existing and proposed pricing flexibility under the price cap rules is AT&T's "headroom": the difference between its APIs, which are weighted indices of its prices, and its PCIs, or the price caps. Including promotions and discount plans in price caps lowers AT&T's APIs, increasing its headroom and its ability to increase basic MTS rates. AT&T's headroom may currently be overstated with unrealized projections of volume for promotions and discount plans. (FNPRM, para. 29.) But this is not the only way for AT&T to game the system. AT&T has also filed numerous transmittals increasing its headroom by the amount of discounts on combined intrastate and interstate usage.[4] By this means, AT&T offsets discounts on *intrastate* rates with increases in its *interstate* headroom. Apparently AT&T includes intrastate discounts in the "price" factor in the API and SBI equations,[5] a practice that makes nonsense of the rule by shifting the costs of intrastate programs to interstate ratepayers.

We also believe it is important for the Commission to consider the following points.

- In late 1994 over sixty percent of AT&T's customers had monthly bills for long distance service of $10 or less. Customers with such low usage levels ordinarily do not qualify for discounts from AT&T's standard MTS rates. Since AT&T has approximately 65 million customers, discount calling plans offer no benefit to more than 39 million of them. Surveys suggest that approximately 49 million of AT&T's residential customers do not, in fact, belong to any discount plan.[6]

- Standard MTS rates have risen. The Commission staff found that AT&T's basic schedule rates increased by 6.5 percent for calendar year 1993 and 5.4 percent in 1994. (FNPRM, paras. 30, 58.) Moreover, AT&T's, Sprint's, and MCI's basic MTS rates move up in lockstep. (FNPRM, n.124.)

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[4] See, for example, AT&T Transmittal Nos. 8155 (February 10, 1995), 8155-A (February 13, 1995), 8156 (February 10, 1995), 8278 (March 10, 1995).

[5] See 47 CFR Sections 61.46(a) and 61.47(a).

[6] See Letter of Alex Mandl, executive vice president and CEO of AT&T's Communications Services Group, to The Honorable Reed E. Hundt, Chairman, Federal Communications Commission, October 4, 1994. According to AT&T's letter, "a total of over 60% [spend] $10 or less in calling per month. About a quarter of AT&T's customers make between $10 and $75 in long distance calling per month, [and] less than 5% of AT&T customers make more than $75 in long distance calls per month." The stated percentages sum to 90 percent.

See also Reply Affidavit of Paul W. MacAvoy in Support of Pacific Telesis Group's Request for a Waiver to Permit It to Provide Interexchange Services to Customers in California, *United States of America v. Western Electric Co.*, Civil Action No. 82-0192 (HHG) (D.D.C.), May 1995 (hereinafter "MacAvoy"). See also William E. Taylor and J. Douglas Zona, *An Analysis of the State of Competition in Long-Distance Telephone Markets*, May 1995 (hereinafter "Taylor and Zona"), attached to these Comments as Exhibit A, p. 24, and *Washington Telecom Week*, May 26, 1995, p. 14.

- AT&T has said that access charges are its single biggest cost.[7] LEC access charges between 1991 and 1994 (inclusive) fell by $5.9 billion from pre-price cap levels.[8] They will fall another $1.2 billion on August 1.

- Telephone penetration began a statistically significant decline in 1993.[9] Studies suggest "the majority of those without telephone service once were subscribers, but have been disconnected for nonpayment of toll charges." (FNPRM, para. 61.)

- Basic MTS and discounted MTS are like services. (FNPRM, para. 38.)

- AT&T's marginal or incremental cost of providing MTS service, whether to "high volume" customers, "low volume" customers, or any others, is not in the record. To our knowledge AT&T has never supported an increase in interstate MTS rates with an average variable cost (AVC) showing.

IV. Response to Requests for Comment

A. AT&T's and its Competitors' Basic Rates

The Commission requests comment on the relationship of AT&T's basic rates to the basic rates of its competitors. (FNPRM, para. 59.) There is more to suggest that AT&T, MCI, and Sprint have increased their basic MTS rates in lockstep fashion than the anecdotal evidence cited by the Commission (FNPRM, n.124). William Taylor demonstrated the lockstep

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[7] See Statement of Robert E. Allen, Chairman of the Board and Chief Executive Officer, AT&T, to the Senate Subcommittee on Communications, September 8, 1993.

[8] *Price Cap Performance Review for Local Exchange Carriers*, CC Docket No. 94-1, First Report and Order, FCC 95-132 (released April 7, 1995) ("*LEC Price Cap Review Order*"), para. 60.

[9] Monitoring Report, CC Docket No. 87-339, May 1995, p. 13.

relationship as early as 1991.[10] The tariffs that prove it are filed with the Commission, which has acknowledged the tariffing process is "an excellent mechanism for inducing noncompetitive pricing."[11]

AT&T has never disputed this. Instead it replies that the Commission should consider its average revenue per minute (ARPM) from all services, not tariffed rates.[12] The Commission has accepted this argument provisionally, saying, "that basic long distance rates have not decreased may be correct, [but] that data fails to capture the effect of optional calling plans and other discounts."[13] In their most recent study, however, Taylor and Zona measure the effect of discounts and rebut the ARPM argument. They find, "AT&T's claimed reduction in ARPM net of access charges is achieved by charging higher prices to low-volume users. Indeed, *any* customer who consumed the same bundle of services in 1994 as he or she consumed in 1984 failed to receive lower prices in the amount of access charge reductions."[14] The principal reason is that AT&T's discount plans are discounts from MTS rates, which have been rising since 1990.

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[10] See W. E. Taylor, "Effects of Competitive Entry in the U.S. Interstate Toll Markets," filed in CC Docket No. 91-141 (August 1991); "Effects of Competitive Entry in the U.S. Interstate Toll Markets: An Update", filed in CC Docket No. 91-141 (July 1992); W.E. Taylor and L.D. Taylor, "Postdivestiture Long-Distance Competition in the United States," *American Economic Review*, vol. 83, no. 2 (May 1993), pp. 185-190; Taylor and Zona.

[11] See Affidavit of Paul W. MacAvoy, January 1995, *United States of America v. Western Elec. Co., Inc. and Amer. Tel. & Tel. Co.*, Civil Action No. 82-0192, pp. 17-19.

[12] See Peter K. Pitsch, *A Brief History of Competition in the Long Distance Communications Market* (hereinafter "Pitsch"), p. 24-27 attached to Letter from Charles L. Ward, Government Affairs Director, AT&T, to Dr. Michael Katz, Chief Economist, Office of Plans and Policy, Federal Communications Commission, September 22, 1994.

[13] *LEC Price Cap Review Order,* para. 61.

[14] Taylor and Zona, p. 24 (emphasis added).

The "discount" prices have been constant percentages of rising standard MTS prices.[15]

Taylor and Zona find that since divestiture AT&T has cut prices $8.521 billion while its access charges fell $10.299 billion.[16] Since price cap regulation began in 1991, AT&T has raised rates $98 million per year while its access charges fell $644 million.[17] On May 9, 1995, the twelve price cap local exchange carriers filed tariffs representing $1.2 billion in access charge reductions. Yet AT&T reflected only $312.8 million to its Basket 1 PCIs, and reduced no rates (it merely continued certain discounts). It also announced that it would raise its rates for small business customers by 5%.[18]

But one does not have to accept Taylor and Zona's conclusions to be troubled by the proposed new rules. The issue is standard MTS rates, not AT&T's total revenues or its discounts. Five years of lockstep increases in those rates speaks for itself. In competitive markets, prices do not ordinarily rise when costs are falling. The Commission concedes (without finding that it is unreasonable) that price discrimination is occurring. Before encouraging further price increases or discrimination the Commission is dutybound to explain why the "low-volume" market, which includes most residential customers, is behaving so anomalously. In the absence of evidence that AT&T is not recovering its costs on standard MTS, it would be irrational and contrary to the interests of consumers to encourage price reductions in the elastic high-volume market to be offset by further price increases in the inelastic low-volume market.

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[15] See MacAvoy, p. 22.
[16] Taylor and Zona, p. 15.
[17] *Id.*, p. 16.
[18] See letter to William F. Caton, Acting Secretary, Federal Communications Commission, from M. F. Del Casino, Administrator-Rates and Tariffs, AT&T, June 22, 1995; AT&T Press Release, May 18, 1995; and *Washington Times*, May 16, 1995, p. B6.

B. Marginal Cost of Serving Basic Rate MTS Customers

As the Commission notes, the "price cap plan for AT&T is intended to afford AT&T the flexibility to adjust prices to approximate more closely marginal costs." (FNPRM, para. 33.) The Commission further notes, "AT&T states that it typically does not recover the incremental costs of providing service to its 'low-volume' basic schedule customers, while its price structure for its 'high-volume' customers has normally exceeded the incremental costs of providing residential long-distance service to them." It therefore solicits comment "on the extent to which the Communications Act's protections against unreasonable discrimination are implicated by the cost issues we raise here, *i.e.*, if rate differences between AT&T's basic schedule services and its discounted offerings reflect a wider variation than corresponding cost differences, at what point do such rate variations become unreasonable?" (FNPRM, para. 62.)

AT&T has said that it does not recover its incremental costs from some "low-volume" customers. AT&T has not said that there is any difference between the incremental costs of basic schedule and discounted MTS. Nor has AT&T said what its incremental cost is, or how many customers in the "low-volume" segment pay prices below AT&T's incremental costs.

The claim that AT&T does not recover its incremental costs is made only with respect to the under $3.00 a month market segment, and it is highly qualified. AT&T's consultant says "*many* of AT&T's customers in the $3.00 a month segment of the market do not cover the incremental costs of serving them. Indeed, on these customers *as a group*, almost 35% of AT&T's customers, AT&T loses money each month."[19] If true, all this statement says is that

[19] See Pitsch, p. 17 (emphasis added).

AT&T fails to recover its incremental costs from a *subset* of 35% of its customers. The actual number of customers is never given. This statement also says nothing about the monthly incremental cost of serving any customer. It may be $2.99, or it may be a penny. AT&T has also said that "[i]n any given month, roughly 10 million of AT&T's presubscribed customers make no calls."[20] It would not contradict any statement of AT&T's if it turned out to be the case that AT&T makes an incremental profit on any customer who makes one call a month.

The assumption that AT&T does not recover its "marginal cost" of serving "low-volume" customers appears to have originated with a chart in an ex parte by AT&T in CC Docket No. 79-252, filed April 20, 1994. (See FNPRM, para. 62, n.138.) It is a bar graph (Chart 1) entitled "Revenue minus Incremental Cost per Customer." The bars depict the relationship of different customer revenue segments (the X axis) to an average difference between revenue and incremental cost represented in the abstract as "1.00" (the Y axis). There are no source notes, no explanation of how the index represented by the Y axis was determined, no dollar and cent figures for revenue or incremental cost. It does not depict AT&T's marginal cost of serving MTS customers. The chart is a model of non-information. It does, however, suggest the number of MTS customers from whom AT&T does not recover its marginal cost is small, because most of AT&T's customers are not in the under $3.00 a month segment, and even some customers in this segment are said to be profitable.

While the incremental cost data that would answer the question is available only to AT&T, considerable evidence suggests that AT&T's and other IXCs' price-cost margins on standard MTS service in California are increasing.[21] On January 1, 1995, Pacific Bell's state

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[20] *Id.*

[21] See MacAvoy, pp. 36-40.

access charges were reduced by an average of 44% for both intraLATA and interLATA calls. In response to this huge decrease in their marginal costs, AT&T, MCI, and Sprint dropped their state *intra*LATA MTS prices substantially to compete with us. But they reduced their basic state *inter*LATA MTS prices by three, three, and zero percent, respectively. In a competitive market, such a large cost reduction would lead to correspondingly large price reductions. Carriers would cut their profit margins to capture customers from their rivals. In the California interLATA market, however, the IXCs simply increased their price-cost margins.[22]

We have no doubt that there are some customers from whom AT&T does not recover its marginal costs. Every business has such customers. But from what we know about AT&T's business, the number of these customers is small. AT&T says, "[t]he incremental costs of serving presubscribed customers is significant, even if they make few calls. They include network, access, and billing costs."[23] This may or may not be true (it depends on how you define "significant"), but in any event it misses the point: whether the incremental cost of serving "low volume" and "high volume" customers is *different*.

What is publicly known suggests that the incremental costs of basic and discounted MTS are scarcely, if at all, different. (1) In our region, unit *access costs* do not vary by customer within a wire center. The only economies of scale we are allowed to reflect in access charges are in trunking, and IXCs' ability to take advantage of these economies obviously depends on the total amount of traffic that originates from an exchange, not from any particular MTS user. (2) We charge AT&T for *billing* on a per-message and/or per-page basis. If no

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22 *Id.* at p. 32.
23 Pitsch, p. 16.

billable calls are made, AT&T incurs no billing cost at all from us.[24] Thus there is little or no difference in unit billing costs between discounted and nondiscounted customers. (3) As for marginal *network costs*, once a fiber-optic interexchange system is laid, carrying additional signals over it is nearly costless.[25] Unit network costs should not be any different for discounted or undiscounted users. The switched traffic of all MTS customers, whatever their "revenue segment," is already aggregated (by us) into an undifferentiated stream of bits or electrons when it enters AT&T's network.

The Commission's proposal would allow further increases in *all* undiscounted MTS rates. AT&T, however, claims only that it fails to recover its costs of serving *some* customers in the *lowest-volume* segment of basic MTS. Obviously, if this is the problem, the Commission's proposed solution is overbroad and unsupported by AT&T's own claims. Stranger still, it ignores an option currently available to AT&T under the price cap rules: the option of filing above-cap rates supported by an AVC showing.[26] An example of such an approach would be a minimum monthly usage charge such as AT&T recently imposed on small business customers. But it would have to be supported with an AVC showing.

AT&T's desire to lift prices for MTS has little to do with rebalancing rates with marginal costs. In reality, AT&T is a low incremental cost enterprise which recovers a healthy

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[24] AT&T says, "in general the rates AT&T pays the independent telephone companies for bill rendering are significantly higher than those paid the Bell Operating Companies." Pitsch, p. 16. Since a disproportionate number of AT&T customers are billed locally by the BOCs, the average figure must be far closer to $.33 than $.88.

[25] See Further Opposition of Bell Atlantic Corporation, BellSouth Corporation, Pacific Telesis Group, and SBC Communications Inc. to AT&T's Motion for Reclassification As A Nondominant Carrier, CC Docket No. 79-252, June 9, 1995, Affidavit of Jerry A. Hausman, para. 17.

[26] See *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 665, 666, 670 (1991).

incremental profit from nearly all of its customers -- even, by its own admission, a number of those who make less than $3.00 a month in calls. It is in AT&T's interest to recover its total company costs by means of discriminatory prices, exploiting the different price elasticities of different customers to the maximum degree regulation permits. It discounts prices to its highest-volume customers, not because their incremental costs are lower but because their demand is more price-elastic. By the same token it has exploited price-inelastic "low volume" MTS customers. By "low volume", we mean the *majority* of AT&T customers who make less than $10 a month in calls, who do not normally qualify for discounts, and whose only choice is therefore to pay the basic MTS rates of AT&T or the essentially identical basic rates of MCI or Sprint.[27]

C. *The Cross-Elasticity of Basic and Discounted MTS*

On the basis of news reports that "53 percent of all minutes of consumer traffic on [AT&T's] network last year were discounted calls," the Commission concludes that customers "shift" from basic MTS to discount plans and promotions. "The evidence of cross-elasticity of demand between basic schedule MTS and APPs [Alternate Pricing Plans] argues in favor of a finding that these services should be classified within the same service category." (FNPRM, para. 42.)

The argument does not hold up. First, even if most of the *minutes* on AT&T's network are discounted,[28] most of the *customers* are not paying discount rates. According to

[27] See FNPRM, para. 45, n.124. The evidence that AT&T's, MCI's and Sprint's basic rate changes move in lock step is abundant and probably as well known to the Commission as it is to us. See n.9, above.

[28] FNPRM, paras. 20, 42. It is impossible to verify these figures, because despite the requirements of Section 61.49 of the Commission's rules, AT&T does not file any band or rate-specific volumes with its annual filing.

AT&T, over 60 percent of its customers have monthly bills for long-distance service of $10 or less.[29] According to another study conducted on 9,000 households in mid-1994, 75 percent of AT&T's residential customers did not belong to any discount plan. The same study concluded less than one-third of all IXC residential calls are billed at discounted rates.[30] Most of America's long distance customers would likely see bill increases, not reductions, as a result of the Commission's proposal to combine MTS and APPs in one price band.

Second, if basic schedule MTS and APPs are "cross-elastic", that merely indicates they are like services, so that for the minority of customers who qualify for APPs, "[p]rice will govern choice."[31] This does not "argue in favor" of including APPs in price caps in the same service category as basic MTS, thereby encouraging further price discrimination between them. It obliges the Commission to examine their costs and explain why discriminatory prices are being charged for like services. If the cost is the same, the Commission "must articulate with precision its reasons for tolerating any discrepancies it uncovers" in the prices.[32]

The Commission speaks of the need to prevent cost-shifting from more competitive to less competitive service offerings. (FNPRM, para. 4.) But it strenuously avoids analyzing the relative competitiveness of the markets for basic and discounted MTS. To say that basic and discounted MTS are "substitutes" only restates that they are like services. What we know for certain about the basic MTS market -- that price increases have been imposed on it with impunity -- suggests it is substantially more inelastic than the discount market.

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[29] See n. 6 above.

[30] See MacAvoy. See also Taylor and Zona, p. 24, and *Washington Telecom Week*, May 26, 1995, p. 14.

[31] See *Ad Hoc Telecommunications Users Com. v. FCC*, 680 F.2d 790, 796, n.13, 797 (D.C. Cir. 1982).

[32] *MCI Telecommunications Corp. v. FCC*, 842 F.2d 1296, 1307 (D.C. Cir. 1988).

At one time the Commission was "concerned about possible unfairness to buyers whose demand was inelastic," such as "consumers with limited choices."[33] Its *Promotions NPRM*, in which it said that "allowing AT&T to insulate itself from revenue losses caused by promotional pricing undercuts one of the basic goals of price cap regulation,"[34] continued this tradition. "If AT&T operated in a completely competitive market," the Commission observed, "this issue would be moot because AT&T could not raise general schedule rates without the fear of losing customers to a competitor."[35] But that is just what AT&T has been able to do, again and again. The Commission must say what, if anything, has changed *about the "low-volume" market* that its observation no longer applies. To the extent that it is "changing its course ... [it] must supply a reasoned analysis indicating that prior policies and standards are being deliberately changed, not casually ignored."[36]

D. *Unreasonable Discrimination*

The Commission asks whether "the Communications Act's protections against unreasonable discrimination are implicated ... if rate differences between AT&T's basic schedule services and its discounted offerings reflect a wider variation than corresponding cost differences" (FNPRM, para. 62).

For reasons we have stated above, the answer from the case law is obviously yes. Basic schedule MTS services and discounted offerings such as Reach Out America are "like" services. (FNPRM, para. 38.) Customers view them as functionally equivalent, with the only

[33] See *National Rural Telecom Ass'n v. FCC*, 988 F.2d 174, 183 (D.C. Cir. 1993).
[34] See FNPRM, para. 13.
[35] *Id.*
[36] *Greater Boston Television Corp. v. FCC*, 444 F.2d 841, 852 (D.C. Cir. 1970), *cert. denied*, 403 U.S. 923 (1971).

difference being price. (See FNPRM, para. 24.) If basic schedule services and discounted offerings cost the same for AT&T to provide, then the Commission must "articulate with precision" why the price difference is not unreasonably discriminatory and unlawful under Section 202(a) of the Communications Act.[37] In practice, unreasonable discrimination is strongly indicated when the difference in price between like services is not explained by any difference in cost:

> In determining whether one charge is unjust or unreasonable by comparison with another, it is by no means sufficient merely to inspect the ways in which those charges arose and the methods by which they were computed. Attention must also be given to the absolute and relative disparity between them.... however reasonable they may appear when viewed in isolation from one another, they cannot be sustained under section 202(a) unless the resulting differences between them, *to the extent that they are based on the costs of like facilities,* are not unjust or unreasonable in amount.[38]

AT&T's suggestion that it fails to recover incremental cost from *some* MTS customers is irrelevant to the "like services" test. The proper inquiry is whether basic MTS and discounted MTS have different incremental costs.

It is equally insufficient to say that MTS and alternative pricing plans should be combined in the same price band because they are "substitutes" for one another. (FNPRM, paras. 24, 35, 42.) In the past, the Commission's policy has been to group together services with "somewhat similar customer bases, demand characteristics, and technology."[39] Basic MTS and APPs are functionally *equivalent* services between which price alone governs choice. When their customer bases and demand characteristics change, it merely signifies that AT&T has

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[37] See 680 F.2d at 792-93; and 842 F.2d at 1307.
[38] 842 F.2d at 1303 (emphasis added).
[39] See for example *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd 6786, para. 221 (1990).

changed the price points between the services. It does nothing to demonstrate the price discrimination itself is reasonable.

E. *Universal Service*

The Commission seeks comment on a number of issues concerning universal service: "what level of scrutiny this statutory mandate requires us to undertake with respect to the basic schedule offerings of the dominant interexchange carrier"; "whether the availability of local telephone service is affected by increases in AT&T's basic schedule rates for interstate MTS"; "the relationship, if any, of increased basic schedule service rates for domestic MTS with the disconnection of local telephone subscribers due to nonpayment of toll charges"; and whether it should adopt one of two options to protect against basic schedule rate increases. (FNPRM, paras. 60, 61, 64.)

As the Commission acknowledges (FNPRM, para. 60), the Act imposes on it an affirmative duty "to make available, so far as possible, to all the people of the United States, a rapid, efficient, Nation-wide, and world-wide wire and radio communication service with adequate facilities at reasonable charges."[40] The recent unprecedented decline in telephone penetration, occurring at the same time as unprecedented significant increases in MTS rates, is strong circumstantial evidence that further increases in AT&T's basic schedule rates for interstate MTS would undermine universal service goals.

The Commission's own data suggest that increasing MTS rates and declines in telephone penetration are related. In its most recent CC Docket No. 87-339 Monitoring Report, the Federal-State Joint Board staff found a statistically significant decline in the annual average

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[40] 47 U.S.C. Section 151.

penetration rate from 1993 to 1994.[41] The positive trend of the 1980s, in which telephone penetration levels rose as rates changed to more closely approximate costs, has been at least temporarily reversed, with telephone penetration declining while MTS rates and IXC gross margins are increasing.[42] The Commission staff found that AT&T's basic schedule rates increased by 6.5 percent for calendar year 1993 and 5.4 percent in 1994. (FNPRM, para. 30.) The Commission also notes "that studies indicate that the majority of those without telephone service once were subscribers, but have been disconnected for nonpayment of toll charges." (FNPRM, para. 61.)

More information is needed. The Commission should preclude any further increases in MTS rates until statistically valid studies by independent auditors or other impartial experts have demonstrated the sensitivity of telephone subscribership to increases in basic MTS rates. AT&T and other IXCs should be required to fund such studies, much as the LECs have been required to fund audits of their cost programs and pooling processes.[43]

If promotions and OCPs are included in price caps, we support the replacement of a residential index with a basic rate index (BRI). However, it would be unjustified to permit increases in the BRI of up to 5 percent per year. As the Commission itself notes, this would permit AT&T to continue increasing basic rates at the same rate as in past years (FNPRM, para. 64), a period that witnessed a decline in telephone penetration rates. The BRI should be capped, with no upward but substantial downward movement permitted.

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41 Monitoring Report, CC Docket No. 87-339, May 1995, p. 13.

42 See Taylor and Zona, p. 42.

43 See for example *Commission Requirements for Cost Support Material To Be Filed with Open Network Architecture Tariffs,* 7 FCC Rcd 1526 (1992); and letter from Donna R. Searcy, Secretary, FCC to Lawrence C. Ware, Chairman of the Board of Directors, NECA, 5 FCC Rcd 7183 (1990).

Whether increases are allowed or not, the BRI should be imposed only after AT&T's headroom has been reformed by the removal of any overestimated demand; of intrastate discounts; and of any accounting costs the LECs are not allowed to reflect in PCIs, as we explain below.

F. *Reforming AT&T's Headroom*

The Commission notes that including APPs in price caps based on forecasted, as opposed to actual, demand may result in overstated headroom. (FNPRM, paras. 29, 49.) The Commission proposes the use of actual demand and cost data upon the conclusion of a ninety-day price period (during which the APP is kept outside price caps). It requests comment on whether such an approach would address its concern about AT&T's headroom. The Commission also asks "how the approach to price cap treatment for APPs ... should be applied to AT&T's existing, on-going promotional offerings which ... are currently under price cap regulation, such as the "True" promotions." (FNPRM, para. 50.)

Contrary to Section 61.49 of the rules, AT&T does not file the volumes and rates used "to calculate the necessary adjustment to the affected APIs and SBIs" in Basket 1.[44] So it is impossible either for us or the Commission to say how much of AT&T's headroom is accounted for by projected volumes for promotional offerings. Something has gone badly wrong when the Commission has to make decisions based on statements to the newspapers by AT&T "Company

[44] 47 CFR Section 61.49(b). The Bureau has routinely interpreted this rule to require submission of revenues (base period demand) in baskets and categories, and "data which can be used to compute the actual price indexes (APIs), service band indexes (SBIs), and subindexes ... [i.e.], base period (calendar year 1994) demand, current and proposed rates, and revenues computed by multiplying the demand by current and proposed rates ... Demand and rate data are [also to be] reported in the aggregate under the primary rate elements of each category." *Cost Support Materials to be Filed with 1995 Annual Access Tariffs,* DA 95-264 (released February 17, 1995), paras 14, 24.

executives" (see FNPRM, para. 42). However, this is not the only example of overstatement in AT&T's headroom.

AT&T has also filed numerous transmittals increasing its headroom by the amount of discounts on combined intrastate and interstate usage ("wraparound" discounts).[45] By this means, AT&T offsets discounts on intrastate rates with increases in its interstate headroom. AT&T includes intrastate discounts in the "price" factor in the API and SBI equations.[46] This does not advance any price cap goals, such as moving prices closer to costs. Instead it shifts recovery of the costs of intrastate programs to interstate ratepayers. We respectfully request the Commission examine this practice, explain how it is consistent with price cap goals, and articulate how it can be reconciled with AT&T's claims of "thriving" and "robust" interstate interexchange competition. (FNPRM, para. 32.)

No public policy is served by encouraging a subsidy from interstate basic MTS customers, who have no meaningful competitive choices, to the more competitive market for intraLATA toll, which still supports basic exchange rates.[47] It does not further the purposes of price cap regulation, which are to encourage efficiency and move prices closer to costs. Although the access charges for the two calls are the same, AT&T's basic schedule MTS rates for intraLATA calls in California are now substantially cheaper than its basic schedule MTS rates for comparable interLATA calls. Nor does "competition" justify a practice that merely

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[45] See, for example, AT&T Transmittal Nos. 8155 (February 10, 1995), 8155-A (February 13, 1995), 8156 (February 10, 1995), 8278 (March 10, 1995).

[46] See 47 CFR Sections 61.46(a) and 61.47(a).

[47] See for example *Re Alternative Regulatory Frameworks for Local Exchange Carriers*, D.89-10-031, 33 Cal. P.U.C. 2d 43, 93 (1989).